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SUBJECT: Reflections on Ecuador's Underperforming Economy

Classified by Ambassador Heather Hodges. Reason: 1.4 b and d.

¶1. (C) Summary. Ecuador has not fully realized the economic benefits of its considerable natural resources and capable work force, in large part because of several long-term factors that create an unpredictable and at times difficult business environment. These constraints include a lack of consensus on economic policy direction, confused views towards investment, weak institutions, and limited respect for contracts. End summary.

¶2. (C) The following comments are reflections of the departing Economic Counselor, who has served two tours in Ecuador. This provides some perspective across time on Ecuador's economic potential, as well as factors that have hindered Ecuador from fully realizing that potential. Although Ecuador possesses many natural economic strengths, missed opportunities and other constraining factors have prevented it from realizing its potential.

Missed Opportunities: Natural Resources and Human Capital

¶3. (C) Although Ecuador has been blessed with natural resources, it has failed to take full advantage of them and has instead fallen victim to the curse of many resource-rich countries. Petroleum is Ecuador's biggest export and most important source of government funding, making up nearly 42% of annual GDP. However, since petroleum was discovered in the 1960s, the government has inconsistently and ineffectively managed its development with an inefficient state oil company and uneven relations with foreign oil companies. Additionally, like other oil-rich countries, Ecuador has allowed its petroleum sector to overshadow other productive sectors such as mining and agriculture, which has made Ecuador extremely vulnerable to the ups and downs of international oil prices.

¶4. (C) Ecuador's agricultural sector, in particular, holds much development potential. Over the years, Ecuador has exploited its ideal growing conditions to become a world-class exporter of agricultural products such as coffee, cacao, bananas, shrimp, flowers, and most recently broccoli. Agricultural export sectors have also been major employers, unlike the capital-intensive petroleum and mining sectors, and they are not subject to the shifting government regulations and contract demands that plague the other sectors.

¶5. (C) Ecuador's use of its human capital has been mixed and inconsistent. Skilled workers often find limited opportunities in Ecuador's economy, yet there are also few standout examples of entrepreneurial activity by Ecuadorians, even given its relatively dynamic agricultural export sector. This is most notable in Ecuador's underdeveloped tourism sector, which has not taken full advantage of its tremendous potential and where many of the newer, more innovative services are offered by foreigners.

Constraints on Economic Development

¶16. (C) There are a number of additional factors that inhibit Ecuador from realizing its economic potential. Some are relatively common in the region: low savings and investment rates, inequality and poverty, insufficient investment in education and health for the poorer parts of society, and a reliance on petroleum that leads to economic volatility and seems to impede other means of wealth creation. This cable discusses four salient factors in explaining Ecuador's failure to realize its economic potential: absence of consensus on the direction of economic policy, a confused and sometimes hostile attitude towards private and particularly foreign investment, weak institutions, and limited respect for contracts.

Lack of Consensus

¶17. (C) Ecuador does not have broad agreement among key elements of society on the direction of economic policy. Instead, the most prominent feature of economic "policy making" in the past two decades has been to block changes that might affect vested interests. There is no broad framework on which most economic players agree as the basis for making reforms. As a result, economic policy orientation has shifted from orthodox to populist, and many initiatives have been blocked or quickly unwound. Unlike preceding governments, the Correa Administration has the political strength to force through many changes, but many of Correa's policies have been hostile towards the business sector, and therefore opposed or grudgingly accepted by important elements of the business community.

¶18. (C) The one economic policy in the last 10 years that has widespread support in Ecuador is dollarization, i.e. the fact that Ecuador adopted the U.S. dollar as its official currency in 2000. Yet even here there is no consensus, since Correa has become a vocal critic of the policy in spite of assurances that he will retain it for the time being. Dollarization by itself is hardly a foundation on which to build economic policy consensus, however, since it essentially removes monetary policy-making from Ecuadorian hands.

Mixed Views on Private/Foreign Investment

¶19. (C) Another factor that constrains Ecuador from fully realizing its economic potential is its confused and sometimes hostile attitude towards investment, both domestic and foreign. Ecuador seems to recognize the need for private investment, including foreign. Ecuador's petroleum reserves were discovered and developed by U.S. companies. Even after the parastatal Petroecuador was established, first as a partner in the Texaco/Gulf consortium, and later to manage the old fields, Ecuador continued to invite foreign participation in Ecuador's petroleum sector. In the mining sector, Ecuador has invited foreign exploration, and issued a mining law in 2000 that was relatively friendly towards private investment. Most other sectors of the economy, with the partial exception of telecommunications, are dominated by the private sectors, with many sectors featuring a mix of Ecuadorian and foreign investment.

¶10. (C) Despite recognizing the importance of private investment, many Ecuadorians do not appear comfortable with it. Concerns exist regarding the exploitative nature of some private ventures, yet many Ecuadorians are also reluctant to accept that reasonable returns and a predictable business environment are key components of private investment. This mixed attitude has led to heavy-handed and inconsistent regulation of certain sectors, notably petroleum, mining, banking and, to a lesser extent, telecommunications. There are numerous examples of harsh treatment of foreign investors by Ecuador, including the seizure of Occidental Petroleum's assets in 2006 and multiple rounds of abortive or incomplete contract renegotiations with foreign petroleum companies since 2006. Outside of the regulated sectors, this confused attitude towards private investment is less obvious and problematic, but it does exist. The Embassy's investment dispute report is disappointingly long for a small country, and covers a number of sectors.

Weak Institutions

¶11. (C) A third constraint on effective, stable economic policy is weak institutions. Ecuador's Congress has been widely disrespected, and was disbanded in 2007 by the Constituent Assembly with little concern expressed by the general public. The judiciary is weak and appears susceptible to political guidance and corruption. In 2005, the President temporarily closed the Supreme Court. Senior judges were replaced again following the adoption of the 2008 constitution. Correa has been successful in consolidating power, but the executive branch as a whole remains weak and has suffered from constant ministerial and administrative turnover. Since policy in Ecuador is traditionally developed at high political levels in a ministry, the constantly shifting leadership has resulted in policies that are subject to frequent changes, particularly when combined with a lack of consensus on the direction of economic policy. Government bodies are also frequently unable to implement new policy guidance, or do so inconsistently.

Contractual Ineffectiveness

¶12. (C) Limited respect for contracts is an additional constraint on Ecuador's economic success. Like earlier administrations, the Correa Administration has attempted to force contractual changes on companies, particularly in the petroleum and mining sectors. Contracts between private entities can also be hard to enforce, in part because of a lack of social norms of adhering to contractual obligations and in part because of the unpredictability of enforcement by the courts. One observer in the early 1990s quipped that once one signs a contract in Ecuador, the negotiating process has just begun. As a result of this contractual uncertainty, many investments tend to focus on short returns and are built on personal relationships.

Comment

¶13. (C) Ecuador has considerable economic potential, some of which has been realized in spite of the constraints outlined in this cable. As a result, over the past two decades the economy has grown, the overall quality of life has improved, and companies continue to have reasons to invest in Ecuador. At the same time, Ecuador's poor or inconsistent economic policies, some of which have been exacerbated by the inconsistency of the Correa administration, have limited growth and represent lost opportunities to improve the well-being of Ecuadorians, particularly the poor. The constraining factors described here have prevented Ecuador from realizing its full potential and have kept it lagging behind the success of its neighbors over the past decade.

Hodges